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TO: COUNCIL MEMBERS

FROM: Irvin Corley, Jr., Director ICJr.

DATE: May 18, 2007

RE: Council President's Questions on the 2007-08 Proposed City Budget

The purpose of this memorandum is to provide responses from Fiscal Analysis to questions prepared by the Council President Kenneth Cockrel, Jr. on the proposed 2007-08 budget.

Question 1: The Mayor is asking Council to adopt the 2007-08 Budget prior to receiving all of the details on the Tunnel deal (the Mayor stated June 15th but Council is expected to adopt the budget May 24th). Personally, I am not ready to bless this deal absent your analysis – do you have enough time between now and May 24th to analyze this deal?

Response: Considering the minimal detail provided on the deal, the complexity of the deal, and the period of time required to have the deal put down on paper, rather than theorized, I do not feel there is adequate time to analyze the deal details prior to May 24, 2007.

More specifically, at least according to the letter of intent document your Honorable Body received recently, there are two key documents the Council has yet to receive for your consideration to approve this deal, namely, the "Definitive Operating Agreement", and the "Interlocal Agreement" between the City and MDOT to create the "Michigan Transportation Agency", which would in turn create the "Detroit Tunnel Authority". It is the Detroit Tunnel Authority that would purchase the Detroit half of the tunnel for $75 million.

I recommend that at a minimum, the Council should receive a draft copy of these documents that are close to a final version as possible before achieving any level of comfort concerning this deal before May 24th.

In addition, the Fiscal Analysis Division needs more financial information supporting the value of $75 million from the tunnel deal. The document entitled "Detroit Windsor Tunnel-Hypothetical Lease Monetization" in the tunnel package your Honorable Body received this past Monday shows a range of present day value of $55.3 million to $86.9 million for Detroit's half of the tunnel. We understand that Goldman Sachs prepared this document for the Kilpatrick administration.

We also understand that the $75 million value is being offered because the City of Windsor had a similar valuation study done by the Price Waterhouse accounting firm, and the high end of its evaluation was $75 million, and that is why the City of Windsor is willing to transfer the amount of $75 million to the Detroit Tunnel Authority to purchase Detroit's half of the tunnel.

We would first like to see the pricing evaluation study done by Price Waterhouse.

In addition, we need to see the total assumptions behind the Goldman Sachs pricing evaluation. Questions that come to mind are:

1. Why were the discount rates of 8%, 9% and 10% chosen?
2. First year of total operating income starts out at $10 million, which is the basis of the net present calculations. What supports the $10 million figure? Why does Goldman Sachs assume only a 2% growth rate? What has been the actual growth rate in tolls over the last five years? What are the vehicle traffic numbers, the last five years, and future assumed numbers, in the pricing evaluation analysis? Why cannot we assume higher growth rates in the future, in the next 75 years? Higher future growth rates would generate a greater present value calculation.
3. We understand the Detroit tunnel operations also receive rental revenues, to the tune of about $1.6 million annually. Why would not this revenue stream also be included in the present value calculation? Does the City of Windsor include this revenue stream in its price evaluation?

Council should note that the Fiscal Analysis Division, Research Analysis Division, the Budget Director and Chief Financial Officer have a conference call at 11:00 am this morning with Goldman Sachs to go over their calculations. Fiscal will report back to the Council the findings of this meeting possibly this afternoon, Monday, the 21st, in the morning, for sure.

We would also like to see the last five (5) years of audited financial statements associated with the operations of the Detroit side of the tunnel. This data would provide historical financial detail regarding toll revenues, rental revenues, operating expenses, capital expenses and lease and tax payments associated with the Detroit tunnel operations.

We also urge the Administration to respond to Research and Analysis Division's memo entitled "Proposed Transaction Regarding the Detroit Windsor Tunnel Between the Cities of Detroit and Windsor, MDOT, and a Transportation

Authority to be Created", dated May 15th, before the Council strongly considers accepting this deal.

Council should note that it appears the Governmental Accounting Standards Board (GASB)'s Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* would govern the accounting for the tunnel transaction. A brief position paper from the GASB is attached.

A key component of the GASB Statement No. 48 is that the tunnel transaction must meet criteria that demonstrate that the City of Detroit would be no longer actively involved with the receivables or future revenues from the tunnel that would be transferred to the Detroit Tunnel Authority, under the Mayor's proposal. The criteria states:

- Neither the government (City) nor the buyer (the Detroit Tunnel Authority) can cancel the sale
- The government (City) cannot limit in any significant way the buyer's (DTA's) ability to subsequently sell or pledge the receivables or future revenues
- The government (City) no longer has access to the receivables, future revenues, or cash collected from them (the tunnel).

This means the Council would need to be able to act on the "Definitive Operating Agreement" under the proposal to effectuate the sale, allowing the Administration to book the revenue in this fiscal year's budget and financial statements. The Council would also need documented proof that the cash ($75 million or so) is available to support the sale and would be in the City's coffers by June 30, 2007.

Again, at this point, Council has neither seen even a draft of the Definitive Operating Agreement, nor a draft of the Interlocal Agreement between the City and MDOT, nor written evidence that the City of Windsor has the cash available to pay the $75 million.

In essence, we feel, at this point, that the Council has insufficient documentation to comfortably agree to keep the $58 million in the proposed budget as a part of the prior deficit appropriation of $31 million.

Council should note that we shared our initial concerns with the Budget Director and Chief Financial Officer. They indicated:

1. **They wanted us to talk with Goldman Sachs (our conference call is this morning at 11:00 am);**
2. **They would work to provide Council draft documents of the agreements cited above;**

3. **They would work with the Administration's legal advisor to respond to RAD's memo;**
4. **They would seek clarification of any timing issues the City of Windsor may have concerning this deal; and**
5. **They would seek information from Windsor providing evidence that the $75 million is immediately available to support this transaction.**

I would like to add that ideally, it would be desirable to receive written documentation that the federal governments of the United States and Canada support this transaction.

Lastly, Council should note too that Fiscal Analysis, along with the Budget Director and the Chief Financial Officer, had a conversation with representatives from the Moody's credit rating agency. In essence, the rating agency would look at both the tunnel deal and the sale of fiscal stabilization bonds as one-time solutions that only gives the City of Detroit more time to bring its operating expenditures in line with operating revenues to achieve structural balance, which is the highest bar for the City to achieve to receive a higher rating. The representatives did, however, indicate that the fiscal stabilization bond scenario would most likely be the least desirable transaction, and it would raise the highest red flag.

However, when we pointed out that the tunnel deal also eliminates the annual rental payment of $700,000 until 2020 from the City's operating revenue stream, which we feel is similar to fiscal stabilization bonds that require debt service coming out of operating funds, the representatives did not necessarily state that the tunnel scenario is necessarily "worse", although in our minds it is fairly equal.

But regardless of either the tunnel deal or fiscal stabilization bonds being in the budget, it is unclear whether these transactions would cause a downgrade in the City's rating, because that would be decided by the credit rating's committee that analyses ratings. Moody's currently rates the City's General Obligation bonds at BAA2, which is a low investment grade, with a stable outlook. It is still unclear whether fiscal stabilization bonds alone would change the outlook from "stable" to "negative". We got the impression that it would take more than the fiscal stabilization bonds to cause a negative outlook.

<u>Question 2</u>: Given the Mayor has added so much to this budget – personnel, departments, et al. What is the cost of all of the "add on's" in this year's budget? (Including pension obligations, health insurance, re-organization costs, I/T, Fusion Center, and General Services Department). I think we need to see a breakout of all the "new proposed costs" in this budget.

<u>Response:</u> The items referred to in this question, such as the General Services Department, in many cases were not added to the 2007-08 budget, but were

added in previous budgets. In the case of the Fusion Center, this was always described as a Homeland Security Grant and not directly funded by the City.

Meanwhile, I believe the second attachment, which is a schedule of "program expansions" in the Mayor's proposed budget that we passed on this past Tuesday, gives a good indication of the "add on" in the 2007-08 budget. This is schedule was discussed at length with the Budget Director during Tuesday's Executive Session.

Question 3: What is Council's Budget Deficit Reduction Plan, especially, if we are unable to secure the Tunnel deal in the prescribed time frame ($58MM) and the land sales ($30MM) complete before May 24th and certainly by the end of the Fiscal year?

Response: First, please be reminded that each of these items is actually being counted by the administration as part of the 2006-07 fiscal year. The effect is to reduce the amount of 2006-07 deficit (including the accumulated deficit) that needs to be funded in the 2007-08 budget. The mayor has included an appropriation in the 2007-08 budget for the Prior Year's Deficit of $31 million. Any dollar amount not collected from the Tunnel Deal, or land sales, that the administration has included in their analysis will potentially increase the deficit, causing the continuation of "rolling the deficit". Since there are so many factors in the estimating of the deficit, other items could also affect the final deficit amount. Should land sales fall $5 to $10 million below the projection, maybe the amnesty collections will offset, some or all.

Under estimating the Prior Year's Deficit during budget development results in building in an increasing rolling deficit, and compounds the problem because spending reductions are not made in a timely fashion. So both the real deficit exceeds the estimate, and spending continues at the unsupported higher level.

Now to answer the question specifically, if Council is not comfortable with the tunnel deal at this point, and any other revenues appear to be too soft, such as land sales, then your Honorable Body could replace the tunnel deal projected proceeds and any extremely soft revenue with fiscal stabilization bonds. As in our response for question 1, we do not feel fiscal stabilization bonds are so much worse than the tunnel deal, even though Moody's feel these bonds is the least desirable transaction.

Another scenario that the Ms. Scales may offer is to push the tunnel deal into fiscal 2007-08 by increasing the Prior Year's Deficit appropriation by $58 million and putting the $58 million as General Fund revenue, which would be generated next fiscal year. Then, Council could put language in the closing resolution that states that if Council does not approve the tunnel deal by September 30th, then the Administration must bring a deficit reduction plan to the Council address any budgetary shortfalls. This puts

the onus on the Administration to bring a bona fide tunnel deal to the table for Council's consideration, or bring a viable alternative to keep the budget in balance. Understandably, Ms. Scales would have to get an agreement from the Mayor before presenting this scenario to the Council.

Question 4: As of today, how far apart are you and Pam Scales on the actual Budget Deficit projected for 2007-08 Fiscal Year? Has the Administration filed a current Budget Deficit Reduction Plan with the State of Michigan? Have you seen it? If so, please furnish a copy to City Council ASAP. If my memory is correct, this time last year it was about $50MM.

Response: There are a number of unknowns, especially going out to the end of 2008, as the question asks. First, I think responding to the anticipated deficit, accumulated, as of June 2007 should be determined. The administration is saying $31 million deficit. Our projection is $78 million, if the tunnel deal goes through. If the tunnel deal does not pan out and property sales come in $15 million short, the deficit could go as high as $150 million deficit going into 2007-08. Until we see major revenues coming in at budgeted levels, get firmer numbers on other revenues, get some actual expenditure information on fringes for the current year, and can estimate the fringe accounts in the new budget compared to the rates, it is nearly impossible to guess the ending position for June 30, 2008 as asked.

I hope this answers the Council President's questions. Please let us know if we could be of any more assistance.

Attachments

cc: Council Divisions
Auditor General's Office
Ombudsperson's Office
Roger Short, Chief Financial Officer
Pamela Scales, Budget Director
Kandia Milton, Mayor's Office

ICJ:I\2007-08\President's Questions for 2007-08 Budget.doc

GASB

Governmental Accounting Standards Board
of the Financial Accounting Foundation

October 2006

GASB Clarifies Difference between Sales and Borrowings

The Governmental Accounting Standards Board (GASB) has issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* to answer governments' questions about how to account for these types of transactions. Although such transactions (for example, those related to delinquent property tax receivables or future tobacco settlement receipts) have become more prevalent, no single standard previously existed to guide how to account for them and report them to the public.

Statement 48 makes a basic distinction between sales of receivables and future revenues, on the one hand, and the pledging of receivables or future revenues to repay a borrowing (a collateralized borrowing), on the other. The answer to the question of whether a transaction is a sale or a collateralized borrowing is important because the cash received from a sale may be recorded as revenue in some cases, but the cash from a borrowing is not—instead, the borrowing results in a liability on a government's financial statements.

The most significant factor distinguishing sales from borrowings is the continuing involvement of the government doing the selling or borrowing. Statement 48 establishes that a transaction is a collateralized borrowing *unless* it meets criteria that demonstrate that the government is no longer actively involved with the receivables or future revenues it has transferred to the other party. The new standards set forth the criteria for determining whether a government continues to be involved. For instance:

- Neither the government nor the buyer can cancel the sale
- The government cannot limit in any significant way the buyer's ability to subsequently sell or pledge the receivables or future revenues
- The government no longer has access to the receivables, future revenues, or the cash collected from them.

For a sale of receivables, the government cannot substitute for or reacquire specific receivables without the buyer's consent. For a sale of future revenues, the government is not actively involved in the future generation of the revenues. In other words, the revenues cannot be the product of goods or services provided by the government or a tax, fee, or charge that the government has to impose. In addition, if the revenues derive from grants or contributions, they cannot depend on the government subsequently submitting applications or meeting performance provisions to maintain eligibility to receive the revenues.

Accounting for Collateralized Borrowings

As noted earlier, if a transaction does not meet the criteria to be a sale, the government pledging the receivables or future revenues should report the proceeds it receives as a liability, not as revenue. It continues to report pledged receivables as assets and pledged revenues as revenues, as appropriate under generally accepted accounting principles (GAAP). The liability is reduced as cash is collected from the pledged receivables or revenues and transferred to the other party.

If the other party to the transaction—the "lender"—also is a government, then it reports a receivable in the amount of the proceeds it gave to the pledging government. The receivable is reduced as it receives the payments from the pledging government.

Accounting for Sales

Receivables that are sold should be removed from the assets in the selling government's financial statements. If there is a difference between the proceeds received by the selling government and the amount of the receivables reported on its financial statements (the *carrying value*), the difference is reported as a gain or loss in the accrual-based financial statements (and as revenue in the modified-accrual-based governmental fund financial statements). Rather than being reported as revenue right away, the proceeds from the sale of a future revenue source generally will be reported as deferred revenue and spread over the life of the sale agreement. In each year of the agreement, a portion of the proceeds would be recognized as revenue.

If the buyer of a receivable is a government that is not a part of the selling government's financial reporting entity, it adds a receivable to its financial statements equal to the purchase price and recognizes an equivalent expense. For the sale of future revenues, the purchasing government (as long as it is not a component unit of the selling government) realizes receivables and revenue when the recognition criteria under GAAP are met—the revenue stream now belongs to the purchasing government.

Intra-Entity Transactions

If the purchasing government is a part of the same financial reporting entity as the selling government, then the sale is an *intra-entity* transaction and the rules are different. For example, a state government might sell receivables to one of its component units, such as a public authority. In this case, the public authority purchasing the receivables should recognize assets equal to the carrying value they had for the state that sold them. The difference between the purchase price and the carrying value would be accounted for as a revenue, expense, or expenditure by the public authority in its separately issued financial statements. However, in the financial statements of the state's reporting entity (of which both the state and the authority are a part), these amounts would be reported as transfers or subsidies between the two governmental entities to avoid double-counting.

In the case of a sale of future revenues between parts of the same reporting entity, the buyer does not add an asset to its financial statements because no carrying value would have been reported by the seller. Assets and revenues would not be reported by the purchasing government until appropriate under GAAP. The purchasing government would report the amount it paid as a deferred charge that would be spread over the life of the sale agreement—each year a portion of the charge would be recognized as an expense or expenditure. The selling government likewise defers the revenue.

Required Disclosures

Governments are generally required by Statement 48 to present disclosures in the notes to the financial statements about the revenues they pledge to collateralize debt, until the debt is fully repaid, including:

- Identification of the pledged revenue source, the amount pledged, and the percentage of the total revenue stream that has been pledged (if it can be estimated)
- Identification of the debt and its purpose
- The length of the pledge
- A comparison of the pledge revenues recognized during the year with the required debt service payments for the year.

The following information should be disclosed about sales of future revenue streams:

- Identification of the revenue sold and the approximate amount
- The period of the sale
- The percentage of the total revenue stream that has been sold
- A comparison of the proceeds of the sale with the present value of future revenues
- Significant assumptions made to approximate the amount of revenue sold and the calculation of its present value.

Implementation Date

Statement 48 should be implemented beginning with fiscal years ending December 31, 2007, though governments may apply the standards earlier. Because the requirements to defer revenues, expenses, and expenditures related to sales of future revenues differ from guidance provided by GASB Technical Bulletin No. 2004–1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues,* governments may apply those provisions prospectively and do not have to adjust the accounting for sales of future revenues completed prior to the implementation date or to restate previous years' financial statements.

2007-2008 CITY COUNCIL EXECUTIVE SESSION - PROGRAM EXPANSION IN THE MAYOR'S BUDGET				
SCHEDULE PREPARED FOR EXECUTIVE SESSION by the Fiscal Analysis Division				
Agency	**GF Position Inc.**	**Item**	**Original**	
				62300
Civic Center	4		249,200	95000
Homeland Security	1		62,300	
Finance	18		1,121,400	
Human Resources	7		436,100	
Human Rights	10	Revenue budgeted to cover costs	623,000	
Law	3		186,900	
Mayor	2		124,600	
Non-Departmental	10		623,000	
Police	61		5,795,000	
Airport		Increase in subsidy from prior year	582,137	
Museum AAH		Increase in subsidy from prior year	150,000	
DDOT		Increase in subsidy from prior year	2,896,496	
Recreation		Funding for Eastern Market in Recreation budget	162,000	
			-	
	116	**Program Expansion in the Mayor's Recommended Budget**	**$ 12,700,633**	